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TAGS: ECON ETRD EIND EFIN RO
SUBJECT: The Lion in Winter: Romania's Foreign Exchange
Policy Changes

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¶1. (SBU) Summary: The National Bank of Romania (BNR), the country's central bank, has recently shifted from its long-standing policy of closely managing the Romanian Leu (ROL) foreign exchange (forex) rate to an infrequently managed free float. The BNR now limits its interventions on the forex market and refrains from announcing when they will occur in advance. The Leu (Romanian for "lion") is gaining strength, causing anxiety for exporters and prompting more interest in tools to hedge currency risk. End Summary.

Increasing Unpredictability in Foreign Exchange

¶2. (U) The National Bank of Romania (BNR), on October 29, switched to an infrequently managed float of the ROL on the foreign exchange market. Since then, the ROL has appreciated 6.3 percent against the Euro and 11.4 percent against the USD, causing a boom for importers and increasing concern among local exporters. The BNR's decision to cease almost daily interventions in the currency market is based primarily on its increasing forex reserves that have grown more than $4.2 billion from the beginning of 2004, now exceeding $14 billion. This amount is well within the IMF-recommended range of reserves equivalent to four to six months of imports. These robust reserves, coupled with a surplus of currency in the forex market originating from foreign remittances, foreign direct investment, and interest income on the BNR's reserves increased the Bank's comfort level with a freer float.

Handling Hot Money

¶3. (U) The BNR has defended its choice of allowing the ROL to float wider and more often as discouraging inflows of speculative or "hot" money. Although Romania officially has always discouraged speculative foreign investments, they were not seriously considered a threat until recently. Historically, this so-called "hot" money naturally avoided Romania due to high investment risk. Today, in spite of incomplete liberalization of the capital account, speculative foreign investment is dramatically increasing due to growing signs of an improved investment environment climate, including:

- -Fitch, the international credit rating agency, recently upgraded Romania to investment grade;
- -Macro-economic indicators, including inflation, unemployment and the budget deficits continue to stabilize;
- -The IMF precautionary standby agreement allows Romania to borrow up to approximately US$367 million if needed and authorized;
- -European Union membership is expected in 2007; and
- -Foreign investors have enthusiastically invested in Romanian Eurobonds, which, according to the central bank, may reach Euro one billion by the end of the year.

¶4. (U) Improved economic conditions set the stage for increased hot money in the Romanian economy. BNR Governor Mugur Isarescu predicts that speculative investments will total approximately Euro one billion by the end of 2004. Speculative investors have been particularly eager to exploit the high interest rates offered on ROL accounts through local banks. Investors can easily benefit from the 11.6 percent annual interest rate on ROL accounts by working through middlemen, a positive spread of 7 to 8.5 percent above Euro-denominated accounts. Speculators exchange hard currency for ROL, invest in interest-bearing ROL accounts controlled by local brokers, then withdraw the money with the intention of quickly exchanging it for hard currency and then exporting the profits. While exchange rates were stable due to central bank intervention, this positive spread was assured. Today, with increasing exchange rate volatility, long-term bank investments, particularly those exceeding six months, may become less attractive for

speculators if the ROL reverses its climb. Investments with short-term maturities become more desirable; investors gain both higher interest and benefit from the current ROL appreciation trend.

¶5. (U) Foreigners resident in Romania will also soon be able to join the group of potential speculators. Currently prohibited from opening ROL accounts on their own, foreigners will be able to open local currency accounts in ¶2005.

¶6. (U) The BNR decided to discourage speculative investment by opting for a freer ROL float, rather than choosing to place restrictions on local banks, such as mandatory investment terms, interest-free short term accounts or early withdrawal penalties. Although decreasing the spread between high interest rates on ROL accounts and low rates on hard currency accounts would also mitigate speculative investments, large cuts are unfeasible at this time due to relatively high Romanian inflation rates. Nevertheless, the BNR has begun a process of lowering interest rates, which now stands at 18.25 percent for commercial banks deposits, a 7.15 percentage point spread compared to the 11.1 percent inflation rate. However, recalcitrant local commercial banks have avoided following the BNR's lead to cut their own interest rates on loans, due to a dearth of competition and risk associated with the domestic lending market.

Keeping Inflation at Bay

¶7. (U) In addition to a desire to discourage speculative investment, the timing for the BNR's decision may also be linked to a desire to apply downward pressure on the 2004 inflation rate, targeted for nine percent. At the nine-month mark, the inflation rate stood at 6.6 percent, and, anticipating the need to purchase fuel for heating for the impending winter, the GOR recognized that maintaining the nine percent goal in the face of significant fuel imports was unlikely. A rapidly strengthening ROL has served to keep inflation under control by making imports cheaper.

Exporters Concerned about Impact...

¶8. (U) Not everyone is happy about the new managed float. Foreign imports are becoming cheaper for the Romanian population and Romanian export goods are becoming more expensive on foreign markets, hurting local manufacturers. The National Association of Exporters and Importers (ANEIR) recently declared that Romanian exporters lost seven to ten percent of revenue within one month as a direct result of the switch. Bank analysts are taking a more conservative stance, preferring to wait for two to three months of data to analyze to what degree the new forex policy affects exporters. ANEIR is calling for dramatic cuts in interest rates to slow ROL purchases from speculative investors, which are a major factor in the currency's appreciation.

¶9. (U) In addition, Romanian businesses are becoming increasingly interested in currency hedging strategies, although this is mainly coming from more sophisticated, medium- and large-sized firms. This growing interest is apparent on the Sibiu commodities exchange where ROL-Euro futures contracts have increased from ten in June, 2004 to almost 1300 during the month of November. ROL-USD contracts have also increased from 19 to 194. Exporters who deal mainly in Euros, importing Euro-denominated inputs, and selling finished products priced in Euros, are virtually immune from the switch, although salaries and local utilities continue to be paid in ROL, which will have a negative effect on profits.

¶10. (U) Romania's Minister Delegate for Foreign Trade recently defended the BNR's policy to let the ROL appreciate, in spite of criticism from exporters. He has called on Romanian exporters to better prepare export strategies and examine ways to become more competitive. He has also has insisted that lower inflation resulting from the new policy will greatly benefit Romanian businesses in the long term. The BNR agrees with this assessment and has described the earlier ROL depreciation against major currencies as an implicit subsidy for uncompetitive Romanian exporters that could not continue.

...But Consumers are Happy

¶11. (U) While exports decline, imports are surging as Romanians eagerly purchase cheaper products from abroad, including machinery, textiles, minerals and automobiles. Embassy's discussions with a major U.S. car manufacturer and importer located in Romania found increasing first-time customer interest in U.S. vehicles and increasing sales overall on European imports. Low cost imports are also benefiting Romanian businesses by allowing them to purchase tools and raw materials for lower capital costs, which will spur growth. However, as imports increase and exports fall, the trade deficit is widening. ANEIR believes that given the current ROL appreciation Romania may attain a record-

high trade deficit by the end of the year.

What the Future Holds

¶12. (U) Capital account liberalization will advance in April 2005, with the anticipated availability of ROL denominated bank accounts for foreigners. This will allow foreigners to benefit from high interest without requiring the services of a middleman. This move may unleash a renewed ROL buying frenzy as speculators move into these accounts. Soon afterwards, The Romanian government will create a secondary monetary market in which domestic T-bills, certificates of deposit and mortgages will be traded and which will likely also be open to foreign residents. This market may also boost confidence in the ROL, perhaps again raising its value.

¶13. (U) The BNR hopes that an additional important psychological boost for the public perception of the Leu as a serious and stable currency will occur next year when it introduces the "new" Leu to replace the old currency unit. The BNR, between July 2005 and December 2006, will divide all current denominations by 10,000, effectively removing four zeros from the bills. The official currency trading designation of the Leu will change from ROL to RON ("Romanian New"). The BNR hopes that this denomination process will assist disinflation through a psychological effect, similar to the results that followed Poland's currency redomination. In the long term, as Romania approaches European Union membership and eventual adoption of the Euro, possibly in late 2014, the BNR believes volatility between the two currencies will diminish. However, where the rate will stand at that time is impossible to predict, all the more so as a new president with center-right leanings and somewhat undefined policy preferences has just unexpectedly been elected.

Comment

¶14. (SBU) Recent foreign exchange policy has shown that Romania has subordinated exchange rate price stability to inflation targeting, a move that is consistent with international standards and best practices. However, this move makes business difficult for those Romanian exporters that may be unprepared for increased international competition as their goods and services become more expensive. This situation is a good test for the more competitive environment that Romania will face in the future as it approaches EU accession. In the short term the ROL will likely continue to appreciate, absent significant interference from the BNR. In the longer term, if Romania's taste for cheap imports continues, and the trade deficit expands, demand for hard currency should slow and reverse current Leu appreication.

Crouch